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Published: 71 Federal Register 2302; January 13, 2006

Comments Due: April 13, 2006

Disposition: Filed

The Agencies propose guidance about concentrations in commercial real estate (CRE). They propose guidance focusing on capital adequacy and risk management practices of institutions exceeding certain CRE concentration thresholds. The Agencies specifically invite comments on (1) the scope of the definition of CRE and (2) the appropriateness of the thresholds for determining elevated concentration risk. **ABA is actively seeking banker responses to the Guidance. Please call or email Paul Smith.**

The guidance sets two thresholds for its application:
(1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital; or
(2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital.

If an institution exceeds threshold (1), it would be deemed to have a concentration in CRE construction and development loans and should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in its portfolio and consistent with other provisions of the Guidance.

If an institution exceeds threshold (2), the institution should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices that are consistent with the Guidance set forth below.

CRE loans are defined as exposures secured by raw land, land development and construction (including 1–4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to Real Estate Investment Trusts (REITs) and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE. The Agencies have excluded loans secured by owner-occupied properties from the CRE definition, because the Agencies perceive these as having a lower risk profile.

Institutions exceeding either the first threshold or the second threshold (after further analysis) should have augmented risk management practices. The recommended practices in the Guidance include:

(1) Board and management oversight of the level of acceptable CRE exposures and implementation of a CRE strategy consistent with risk tolerance. "Directors, or a committee thereof, should explicitly approve the overall CRE lending strategy and policies of the institution. They should receive reports on changes in CRE market conditions and the institution's CRE lending activity that identify the size, significance, and risks related to CRE concentrations. Directors should use this information to provide clear guidance to management regarding the level of CRE exposures acceptable to the institution."

(2) Addressing the CRE strategy in the institution's strategic plan. Strategic planning should include "an analysis of the potential effect of a downturn in real estate markets on both earnings and capital and a contingency plan for responding to adverse market conditions."

(3) Instituting clear and measurable underwriting standards in its lending policy with only limited, documented, exceptions. Underwriting standards should include:

- Maximum loan amount by type of property,
- Loan terms,
- Pricing structures,
- LTV limits by property type,
- Requirements for feasibility studies and sensitivity analysis or stress-testing,
- Minimum requirements for initial investment and maintenance of hard equity by the borrower, and
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

(4) Instituting policies specifying requirements and criteria for risk rating CRE exposures, ongoing account monitoring, identifying loan impairment, and recognizing losses. Risk ratings should be risk sensitive, objective, and tailored to the CRE exposure types underwritten by the institution.

(5) Identifying and managing concentrations, performing market analysis, and stress testing CRE credit risk on a portfolio basis.

(6) Maintaining MIS systems that are adequate go provide, on either an automated or manual basis, stratification of the "portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. Institutions should be able to aggregate total exposure to a borrower including their credit exposure related to derivatives, such as interest rate swaps. MIS should maintain the appraised value at origination and subsequent valuations."

Further, the proposed guidance states that institutions with CRE concentrations should have capital levels above the minimum regulatory capital commensurate with the level and nature of risks to which they are exposed. While the proposed guidance does not set forth specific increased capital requirements, it states that institutions should make use of the results of any stress testing and other quantitative and qualitative analysis (including an assessment of the potential for future losses on CRE exposures) to perform an internal capital analysis in order to derive an adequate capital cushion.

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